What the Fair Credit Reporting Act Should Teach Us About Mortgage Servicing

Progressive Recommendations to Protect Home Mortgage Consumers

Peter Swire January 2011

Introduction

Our nation's recent housing crisis revealed deep flaws in the way monthly mortgage payments by homeowners are handled by mortgage servicers—the companies that collect monthly mortgage payments from homeowners and forward the payments to investors in those mortgages. These flaws go far beyond the recent and headline-grabbing robo-signing scandals, in which many mortgage servicing companies were found complicit in shoddy handling of the legal requirements for foreclosure. Other major players in the housing market are deeply dissatisfied with the current system, including private investors in mortgages that have been bundled into mortgage-backed securities, mortgage insurance companies, and the two big mortgage finance giants that are now in government conservatorship, Fannie Mae and Freddie Mac.

So, too, are the consumers of home mortgages—the more than 50 million homeowners who write monthly mortgage checks to mortgage servicing companies. This issue brief presents a new analysis of how consumers are systematically disadvantaged by the current system of mortgage servicing, in which mortgage servicing rights are governed legally to protect the interests of investors and mortgage servicers before the rights of consumers are ever considered.

As the mortgage servicing industry evolved in the past decade, a major market failure developed—they owe their responsibility only to investors, and owe no duty at all to consider the needs and interests of consumers. Amid the housing crisis that began in 2006 and metastasized over the next four years, it became increasingly clear this type of market failure precisely tracks the problems that led

to creation of the Fair Credit Reporting Act in 1970—harms to consumers when the large financial companies responsible for consumers' credit ratings served the interests of their major corporate clients rather than consumers. That market failure four decades ago was corrected by FCRA, which requires the three big credit rating agencies—Equifax, Experian, and TransUnion—to give individuals the right to see their credit history and to correct mistakes. Over time, Congress strengthened these consumer protections under FCRA, notably in overhauls in 1996 and 2004.

That same market failure corrected by FCRA in consumer finance is now readily apparent in the mortgage servicing marketplace. After all, some of the biggest consumer issues in a family's life—whether they can stay in their home, on what terms, and paying how much in fees—is a realm of finance over which consumers boast little to no leverage. What's more, mortgage servicing rights are not specifically addressed in the financial regulatory reform law passed by Congress last year.

The upshot: An effective set of consumer protection rules should be a priority of financial regulators, the new 112th Congress, and the Obama administration in the response not just to the robo-signing scandals but also the creation of our next generation of housing finance as Congress and the administration grapple with how to replace the mortgage finance roles played by Fannie Mae and Freddie Mac. This issue brief offers some progressive recommendations for how this could be done to the benefit of consumers and our mortgage finance system.

From robo-signing to investor concerns

A series of congressional hearings late last year regarding the "robo-signing" scandal raised the question of what to do about mortgage servicing rights. The robo-signing scandal involved employees of major servicing companies who admitted that they routinely, falsely signed documents under oath in court cases. Once Congress and the press began to look under the hood of servicing practices, other serious problems emerged, including the question in many cases about whether servicers followed the requirements for endorsing the "notes" (proof of ownership of a loan) as required before a foreclosure can legally occur.

The robo-signing hearings brought new attention to longstanding complaints about mortgage servicers. The Obama administration's Home Affordable Mortgage Program, or HAMP, a mortgage-modification program for embattled but credit-

worthy homeowners, has been plagued by slow action by servicers. For instance, Bank of America Corp. did not complete a single permanent mortgage modification by the end of 2009, and the attorneys general in two states brought a new lawsuit against Bank of America in December for numerous alleged unfair or deceptive practices.[1] There have been numerous complaints about lost documents, slow service, and servicer mistakes about putting houses into a foreclosure sale while a different part of the same servicer was agreeing to a mortgage modification.

On the financial side, mortgage servicers are being hit by enormous claims for damages from a range of actors. Fannie Mae and Freddie Mac are seeking billions of dollars of "putbacks," or payment back to them for mortgage origination and servicing during the housing bubble that violated the legal requirements of the two then-government-sponsored enterprises, both of which are now effectively government owned. Those putback demands are based on the documented fraud and abuse committed by many mortgage originators and servicers during the bubble as they sought to create more and more mortgage-backed securities for sale to eager institutional investors worldwide. Major lawsuits by private mortgage insurance companies similarly claim that they paid billions of dollars in insurance claims to investors in these mortgages for loans that were not properly originated and serviced.

Some of the sharpest complaints have come from investors in so-called "private-label securities," the mortgage bonds created on Wall Street during the bubble without any payment guarantees from Fannie Mae or Freddie Mac. These private-label securities were issued and sold separately from the so-called "conforming" mortgage-backed securities that Fannie Mae and Freddie Mac guaranteed. Investors in private-label securities essentially claim that servicers have not been faithful agents for investors; servicers are supposed to act on behalf of the investors under the contracts that hired them.

Among other concerns, investors worry that servicers have been making judgment calls to the advantage of the servicers themselves rather than the investors the contracts say they are supposed to work for. Other affiliates of the major servicers, for instance, hold the bulk of the home equity lines of credit and other junior mortgage claims. This means they are incentivized to maximize value of these second-lien mortgages over the first-lien mortgages. The concern is that servicers often make modifications and other decisions in ways that benefit the supposedly "second-in-line" lenders (the servicers) in front of the "first-in-line" investors.

In the wake of the historic housing bubble, it is entirely predictable that major players in housing finance are now pointing the finger of blame at each other, and suing each other over who should suffer the unprecedented losses caused by housing price declines. The robo-signing scandal and recent hearings in Congress, however, provide a teachable moment about the need for fundamental reform in how mortgage servicing rights are treated in the American housing market. Indeed, in a recent hearing, Sheila Bair, chairman of the Federal Deposit Insurance Corporation, called for "broad based reform of mortgage servicing" to address "misaligned incentives." The same day, Daniel Tarullo, governor of the Federal Reserve Board, called for "new national standards for servicers."

We may be seeing the beginning of agreement around a simple but crucial point: The next generation of mortgage finance in this country requires major reform in the way that homeowners pay their monthly mortgages. Fannie and Freddie, the Federal Housing Administration, private mortgage insurers, and private investors all have expressed severe concerns about bad incentives in the current system. To assure liquidity for our future housing market, we need better ways for investors and guarantors to be confident that servicing is being conducted with the correct incentives. And all this can be done while also protecting the rights of consumers of home loans—all 50 million of them.

The switch to a new mortgage servicing market

As reform proposals are developed for investors in home mortgages and guarantors of those loans, it is critical to reform the system so that it works better for another group—the homeowners of America. More than 50 million American families pay their mortgage each month. Until quite recently, few of them were harmed by bad servicing. Today, in contrast, the modern shape of the servicing industry means that families are open to harm from servicers, with essentially no control by legal remedies or market discipline.

This harm to homeowners is a recent phenomenon. Historically, most mortgage loans were made locally by thrifts or commercial banks. Even if the loans were later sold, the lender often handled the monthly mortgage payments, which meant that the lender had the usual market incentives to treat borrowers well because the local lender hoped to provide other banking services to the family, such as a deposit account or a new mortgage loan in the future.

Over time, this local lending and servicing gave way to servicing by specialized third parties, especially after creation of those private-label securities on Wall Street in the late 1980s. By the late 1990s and early 2000s, the economics of the servicing market led to two trends. First, a much larger proportion of local lenders sold off the mortgage servicing rights rather than keeping them in-house. Second, market concentration in the servicing industry skyrocketed. The 10 largest servicers had an 11 percent market share in 1989, climbing to 40 percent a decade later, according to the Handbook of Mortgage-Backed Securities. Today, the top four servicers have more than 70 percent of the market. As a result, the policies of a small number of financial giants now govern how most homeowners are treated if there is any difficulty in paying the mortgage.

The steady rise of housing prices until recently masked the effects on consumers of the new market structure for mortgage servicing rights. When home prices are rising, there is an easy way out for homeowners who lose a job or otherwise face problems in paying the mortgage—just sell the home for a profit. As long as house prices stay even or go up in the meanwhile, the family can pay back the mortgage and move to a rental unit. Things were even easier during the easy-credit days of the housing bubble. If a family started to fall behind on the first mortgage, rising housing prices meant that the family could "tap their equity" in the home and get a second mortgage to keep current with the first mortgage payments. Or, during the same easy-credit period, many families could put the monthly mortgage on their credit cards, and avoid default that way.

The housing price collapse that began in 2006 exposed the problems in the mortgage servicing industry. The rate of delinquent mortgages climbed rapidly, from less than 2 percent of mortgages to more than 10 percent today. The easy cures from yesterday were no longer usually available, such as second mortgages or large loans on a credit card. Instead, more than 10 million homeowners found themselves "under water" in a home they could not sell without losing money and thus in a new position—negotiating with mortgage servicers about whether they could stay in their homes, on what terms, and with what fees.

The precedent of the Fair Credit Reporting Act

This history of mortgage servicing shows the new ways that mortgage servicers hold power over many homeowners as the structure of the mortgage market has

A key disconnect

At present, the Fair Credit Reporting Act does not apply to mortgage servicing companies

	Fair Credit Reporting Act	Mortgage servicing
The companies that affect consumers	Credit reporting agencies, or CRAs	Mortgage servicers
The clients of those companies	Lenders, insurers, etc.	Investors in mortgages
Protections for consumers	Fair Credit Reporting Act	None currently

changed and its effects have become visible for the first time. This structure turns out to parallel exactly the problems that led to creation of consumer protections under the Fair Credit Reporting Act. (see Table)

This table shows the parallel structure of the credit rating market and the mortgage servicing market. For credit reports, the three major credit reporting agencies—Equifax, Experian, and TransUnion—dominate the market for consumers' credit histories. Mistakes and decisions about credit can have a large impact on a family, whether a mortgage or auto loan is approved, for instance, and on what terms. The clients of these credit agencies, however, are not consumers. Instead, the agencies make their money by selling credit reports to lenders, insurers, employers, and others. The market incentives for these companies are to give their corporate clients what they want, rather than to worry about how a mistake affects an individual consumer.

The history of the credit reporting agencies parallels the recent history in mortgage servicing. The credit reporting industry consolidated greatly during the 1960s. A series of congressional hearings showed that individual consumers often had serious mistakes in their credit histories, but the credit rating agencies had no good procedures to handle consumer complaints. For instance, the hearings showed that consumers lacked any protection when a lender incorrectly reported they had paid late, and individuals were turned down for loans and jobs as a result.

In light of these problems, Congress passed the Fair Credit Reporting Act of 1970, which gave individuals the right to see their credit history and to correct mistakes. Over time, Congress strengthened consumer protections under the FCRA, notably in overhauls in 1996 and 2004.

The same problems now plague the mortgage servicing market. First of all, the national market has consolidated into the hands of a few servicers. Secondly, these servicers make vital decisions about consumers, such as whether to forgive

a late payment, modify a mortgage, or foreclose on the house, and with what (often large) fees paid by the homeowners. The clients, however, are financial corporations, such as investors or mortgage guarantors. These clients have their own complaints about the current system, as discussed above. The clients, however, at least have protection by contracts that say the servicers are supposed to act on the clients' behalf, and these contracts are the basis for current lawsuits against servicers.

Consumers have no similar protections. They are simply "third parties," people who are affected by the contract between the investor and the servicer but play no part in drafting the contract. As with the credit rating agencies, consumers have no choice about which servicer handles their mortgage. Consumers choose a mortgage originator when they get a mortgage but the originator now routinely sells that mortgage to an outside servicer with no choice in the matter for the homeowner.

In short, consumers exert no market pressure on servicers. A servicer can provide lousy service and the homeowner has no way to exit. Even if the consumer tries to refinance the mortgage, the new originator can sell the servicing rights to the same lousy servicer as before.

What to do next

This simple point has not been part of the public debate to date about mortgage servicing companies. The United States has long required effective consumer protection rules under the Fair Credit Reporting Act but the same sorts of problems in mortgage servicing currently lack any similar consumer law. Quite simply, there is a large market failure. Consumers are subject to bad service and large losses, with no effective market checks or legal redress in place.

The point of this issue brief is to point out the market failure rather than to propose the full set of possible policy responses. Yet there are some common threads that should inform the coming debate. New consumer protections could come from a variety of sources. First, it might usefully be part of the reform of Fannie and Freddie that Congress is scheduled to consider this year. The logic for fixing the mortgage servicing program through this legislative avenue is strong—any new system of housing finance must first have an effective payment system so consumer mortgage payments will flow correctly through the system to investors.

Second, and more immediately, consumer protection rules can be crafted into any settlement that the state attorneys general and federal regulators may reach soon with servicers in the robo-signing scandal. Third, the new Consumer Financial Protection Bureau might consider drafting mortgage servicing regulations once the Bureau is up and running next year. In addition, there have been press reports that financial regulators may include some consumer protections related to servicers in the proposed rule about "Qualified Residential Mortgages" that the Dodd-Frank Act mandated.

In terms of specific consumer protections, consumer and industry experts should weigh in on what the overall approach should include. To begin the discussion, here are three traditional categories of consumer protections to consider:

- Disclosure
- Deception
- Conflicts of interest

Let's consider each in turn.

Disclosure

Mortgage servicers should disclose their fee schedule, including for the contractors they hire in the foreclosure process. For credit and debit cards, we have seen new consumer protection rules around transaction and late fees. The risk of problems is even greater in mortgage servicing, where consumers have no option to exit from an abusive servicer.

Servicer fees are often paid out of the proceeds of a foreclosure, and a recurring complaint has been that such fees give too great an incentive to foreclose rather than work out a modification. Disclosure of a servicer's fees, perhaps both to the homeowner and to consumer protection enforcers, is an important first step toward reducing abuse.

Deception

The new lawsuit against Bank of America's mortgage servicing affiliate alleges employees were trained to mislead consumers who called with complaints about mortgage servicing. Regulators already have general powers to enforce against "unfair and deceptive practices" by servicers. They should do so.

More specific rules about common categories of deception are worth considering. As with FCRA, consumers perhaps should be entitled to moderate-sized statutory damages where a servicer has engaged in a pattern of deception.

Conflicts of interest

Most mortgage servicing today is done within the largest financial holding companies. One major concern about the current system is that the large servicers may be protecting affiliates who hold second liens on homes in the form of home equity loans, at the expense of the first-lien holders—the investors—who they supposedly work for. When conflicts of interest exist, consumers come third, after the investors and servicers, and the servicer has no legal duty to act in the consumers' best interest.

Other aspects of banking regulation have strict conflict-of-interest disclosures and regulations, such as the limits on transactions between an FDIC-insured bank and its affiliates. New measures should be considered to ensure that servicers are acting on behalf of investors and consumers, rather than for the benefit of their lending affiliates.

The way forward

The recent history of mortgage servicing highlights an important new development—only rarely does such a large, concentrated industry arise in ways that can have such important negative effects on tens of millions of consumers. There is little reason to think the system that developed during the housing bubble is the correct system going forward. FCRA provides a model for showing that the rights and needs of consumers should not continue to be ignored in our system for mortgage servicing.

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Endnotes

1 Andrew Martin and Michael Powell, "Two States Sue Bank of America Over Mortgages," *The New York Times*, December 17, 2010, available at http://www.nytimes.com/2010/12/18/business/18mortgage.html.